FILE COPY

SEP 22 1948

CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1948.

No. 202.

EUTERPE ECONOMOS, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BRIEF IN REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

THOMAS M. WILKINS,
Counsel for Petitioner.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX.

CITATIONS.

CASES: Page

Armstrong v. Commissioner, 143 F. 2d 700 6
Commissioner v. Lusthaus, 327 U. S. 293.....1, 2, 3, 4, 5
Helvering v. Clifford, 309 U. S. 331.....2, 3, 4, 5
Paul v. Cullum, 132 U. S. 539 ..... 2, 6
Poe v. Seaborn, 282 U. S. 101 7
Tower v. Commissioner, 327 U. S. 280.....1, 2, 3, 4, 5

STATUTES:

Internal Revenue Code:

Sec. 22(a) 2
Sec. 161 2

Regulations:

Regs. 111 Sec. 29.22(a)-21 .....2, 3, 6

IN THE

Supreme Court of the United States

OCTOBER TERM, 1948.

No. 202.

EUTERPE ECONOMOS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

BRIEF IN REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

The Government in its reply brief has completely ignored the very crux of this case, which was stressed in the argument in the petition for certiorari, namely that, quite unlike the cases of *Tower* v. *Commissioner* 327 U. S. 280 and *Commissioner* v. *Lusthaus*, 327 U. S. 293, there was no proof here of a control of the *disposition* of the disputed partnership income, for the benefit or use of the petitioner. Quite on the contrary, the positive proof here shows that the beneficiaries shares of the partnership income were not disposed of and could not be disposed of by or for the benefit of the petitioner for her own purposes, including family purposes. (R. 6-8)[1]

---

[1] The record citations herein designated "R" refer to the portions of the Transcript of Record. Those designated "Tr" refer to the unprinted portion of the record as certified to the court by the Clerk of the Court of Appeals for the Fourth Circuit.

Without this end result, that the petitioner controls the disposition of the partnership income, the Tax Court would not be justified in this, or any other case, in ignoring the partnership. Furthermore, without positive proof that the partnership here was but a mere pretense, it is not material that the trustee and the beneficiaries contributed no capital of their own and performed no vital services in the business. *Paul* v. *Cullum*, 132 U. S. 539, 550. It is not a usual or necessary characteristic of a trust that either the trustee or the beneficiary make such contributions of capital or services and Congress recognizes this in recognizing trusts as taxable entities. Sec. 161 of the Internal Revenue Code.

The instant case is a trust case. It should be governed by the same fundamental principles, which the Government designed as the basis for Regulations 111 Sec. 29.22 (a)-21. TRUST INCOME TAXABLE TO THE GRANTOR AS SUBSTANTIAL OWNER THEREOF.

In the case of *Helvering* v. *Clifford*, 309 U. S. 331, which involves a trust, the Government successfully argued the fundamental proposition, which is the sole issue here: who controls the disposition of the income in dispute? As stated in the *Tower* case at p. 288 of 327 U. S., the purpose of Section 22 (a)of the Internal Revenue Code is "to tax all income against the person controls its disposition" and that this purpose "could not be frustrated by family group arrangements even though • • • valid for state law purposes."

In both the *Tower* and *Luthaus* cases, supra, this identical fundamental principle was argued and applied by this Court and partnership income was taxed against the persons who *controlled the disposition* of it. That principle was also the issue in those two cases.

The above-mentioned regulations were promulgated following the *Clifford* decision, supra. These regulations, as amended, comprise a very detailed set of analytical rules for trust cases, embodying these same fundamental prin-

ciples for determining, for tax purposes, the factual question of what person *controls the disposition of income* under varying circumstances. Under these tests, as set forth in these Regulations, the petitioner here does not control the disposition of the trust income. The income here cannot be spent or used by the petitioner for her own or for family purposes. It may only be employed in the business, being accumulated with the corpus for only a short period, solely to protect the beneficiaries against their own improvidence, and to earn more income for them, after which the accumulated income and the corpus must be distributed to the beneficiaries to use as they please. (R. 6-8)

While these Regulations, as amended, purport to embody the same fundamental principles for determining the *control of the disposition of income*, which were applied by this Court in the *Clifford*, *Tower* and *Lusthaus* cases, supra, these same principles are arbitrarily avoided as tests where, as here, the creator of a family partnership is the grantor. In such cases the Government stands solely upon the mere "formalism" that a partnership is involved and refuses to be guided by the fundamental question of who *controls the disposition of the income*.

Although this case started out in the Tax Court a trust case alleged to come within the principles of the *Clifford* case. (Tr. 6, Tr. 20), the Government, immediately after the *Tower* and *Lusthaus* decisions, shifted from that premesis to the purely technical view that all underlying fundamental principles can be disregarded merely because of the "formalism" that the creator of a partnership is involved. (Tr. 11, Tr. 20). In order to do so, it has invoked the obviously false premise of attributing to this Court in the *Tower* and *Lusthaus* decisions, the supposed principle that, even in the case of a business in which capital is a material income producing factor, no partnership can exist for tax purposes between close relatives as to one who contributes neither capital of his own nor services to the busi-

ness, irrespective of who "controls the disposition of the income." No decision of this court is authority for such an arbitrary principle. Such a decision would constitute judicial legislation.

Although this is a trust case, the Government refuses to measure the particular circumstances here by its own Regulations embodying the fundamental principles for determining the one to whom it would tax the income, namely, the one who *controls the disposition of it*. Under those tests, devised by the Government itself, the income would not be taxable to the petitioner here.

The Government has deliberately avoided every discussion of those fundamental principles as applied to this case. It did not even cite the *Clifford* case in its argument before the Tax Court, the Circuit Court of Appeals below or in its brief in opposition here. While the Government stands here on a baseless "formalism", in total disregard of the fundamental principles involved in this class of cases, at the same time, it imputes to this petitioner an advocating of "the very type of formalism" by which it is avoiding the applicability of the fundamental principles which are applicable here.

On page 8 of Respondent's brief in opposition, the following statement appears:

> In the *Tower* and *Lusthaus* cases, *supra*, this Court indicated that the decisive question in such cases is not who may own a share of capital but who produced the income."

In the case of a business in which capital is a material income producing factor, this Court has never taxed the income to one who neither owned the share of capital which produced it nor controlled the disposition of the income. That is what the Government is asking this court to approve here. The above quotation constitutes an over simplification of the issue and ignores this Court's admonition in the *Tower* decision, that, "those issues cannot be decided simply by looking at a single step in a complicated transaction." What this Court said at this point in the

Tower case, was that the issue of *who produced the income* "depends upon whether this husband and wife really intended to carry on business as a partnership". And that question in the *Tower* and *Lusthaus* cases was decided, not upon who invested the capital and who performed the services, so much as it turned upon the question of the actual final disposition of the income in question, namely the "end result of the creation of a husband and wife partnership".

The "end result" of the creation of the partnerships in both the *Tower* and *Lusthaus* cases, "is that income produced by the husbands efforts continues to be used for the same business and family purposes as before the partnership." (327 U. S. 291) This factor in both the *Tower* and *Lusthaus* cases, as in *Clifford* case, conclusively disposed of the question of who *controls the disposition of the income*. It is the controlling factor in these cases, not whether or not the purported partner contributes capital of his own or performs vital services. "It is the command of the taxpayer over the income which is the concern of the tax laws". (327 U. S. 290)

In the *Tower* case, if the wife had contributed her capital from her own wealth instead from her husband's wealth, it would have followed from this Court's reasoning, that the wife was the one "who produced the income", whether she performed any services or not. But what is most important, if as here, the income could not be used for family purposes, the same as before the creation of the partnership, and if the wife had disposed of the income for herself for some use of nature other than that which "a husband usually buys for his wife such as clothes and things for the family or to carry on activities ordinarily of interest to the family as a group," (327 U. S. 286) the Tax Court would not have been justified in regarding the partnership as a pretense or a sham. If the income had not been so used, there would have been no factual basis for the assumption that the parties did not intend to carry on business as partners and the failure to contribute capital

of her own or vital services would not have been material. Proof of personal investment or contribution of vital services is material only to *rebut* the positive proof that the partnership was a sham. Lack of such investment or contribution of such services is not material, standing alone, as proof of that ultimate fact. *Paul* v. *Cullum, supra.* Standing alone, proof of such failure to invest or to perform services does not dispose of the issue here of who controls the disposition of the income.

If petitioner here controls the disposition of the income in question, it must be taxed to her as if she produced it. If the trust controls the disposition of the income for the benefit of the beneficiaries, the trust, being the owner of the capital, "produced the income" and it is taxable to the trust. That is the issue here.

In this case: (1) The fact that there were valid transfers to valid trusts was stipulated and found as a fact. (R. 3 and 5); (2) the trusts are irrevocable (R.8. par. 5); neither the corpus nor the income can revert to or be disposed of or impaired in any way by the grantor. (R. 7, par. 3.b.); (4) the income which is accumulated in the trusts and the corpus of the trusts must be distributed upon such termination solely to the beneficiaries (R. 7, par. 3.a); (5) the grantor does not control the disposition of the income of the trusts.(R. 6); and the petitioner and the trustee of the two trusts have the right to withdraw their profits from the partnership in such amounts and at such times as they may mutually determine (R. 11, par. 10).

Under the regulations, also, the disposition of the trust income is not controlled by the petitioner and the income is not her income.

The decision of the Circuit Court of Appeals below is clearly in conflict with the decision of the United States Circuit Court of Appeals for the Tenth Circuit in *Armstrong* v. *Commissioner*, 143 F. 2d. 700. The material facts in both cases are clearly "on all fours" with each other.

The decision below is in conflict with the decision of this court in *Poe* v. *Seaborn*, 282 U. S. 101, in that this court held there that the words of the statute levying a tax "upon the net income of every individual", required the income to be taxed to its owner, because: "The use of the word 'of' denotes ownership." Here, as in the *Poe* case, the income in issue never at any time vested in the petitioner under local law, nor does the petitioner have *control of the disposition of the income* in issue. In the instant case the ownership of the income is at all times vested in the trustee and the beneficiaries and never has vested in the petitioner, nor does the petitioner have control of the disposition of the income, nevertheless the decision of the court below has taxed the income to the petitioner contrary to the principle laid down in *Poe* v. *Seaborn, supra.*

It is therefore respectfully urged that a writ of certiorari be issued in this proceeding.

Respectfully submitted,

THOMAS M. WILKINS,
Attorney for the Petitioner.